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TAGS: EFIN ECON TU
SUBJECT: TURKEY: IMF MISSION SEES NEED FOR NEW FUND
PROGRAM, GOT STILL UNDECIDED.

Classified By: DCM DOUGLAS SILLIMAN FOR REASONS 1.4 B AND D.

¶1. (C) Summary: Ambassador Wilson hosted IMF Mission Head Lorenzo Giorgiani, new IMF Turkey Desk Director Rachel Van Elkan, IMF Turkey Mission Chief Hossein Samei and Deputy Mission Chief Davide Lombardo for a breakfast with G-7 ambassadors on October 23. Giorgiani said the GOT has not yet asked for a new IMF program, despite hints that the Mission's presence would be a good opportunity to begin those talks. Prime Minister Erdogan has not decided yet whether the financial benefits of a new IMF program in avoiding a financial crisis outweigh the spending restraints a program would entail and the IMF,s political stigma in upcoming local elections. The Turkish economy already is slowing down,
and the private sector will feel most of the impact of this crisis due to its high debt. Despite a healthy banking system, Turkey will need USD 140 billion in FX financing in 2009 and will face difficulties in getting all of that amount. Central Bank reserves are insufficient to meet FX debt repayments as well as potential non-resident investment sales. Giorgiani urged the G-7 ambassadors to encourage the GOT to take out an IMF "insurance policy." The GOT also needs to work on contingency planning for a crisis, revise its medium-term fiscal framework, restrain fiscal spending and make the 2009 budget consistent with its 3% primary fiscal target. Later on October 23, Treasury Minister Simsek announced that Turkey does not want a Standby agreement with the IMF, but is still considering a Precautionary Standby agreement. However, the GOT still has not formally asked the IMF for a new program. End summary.

No GOT Request for New IMF Program

¶2. (C) Giorgiani emphasized that the team is in Turkey for Post Program Monitoring, not to negotiate a new IMF program agreement with Turkey. However, the team told Treasury Minister Simsek that if the GOT plans to ask for a new IMF agreement in the near future, it would be good to start those discussions now while the team is in Turkey, rather than calling the team back a few weeks later. Simsek took the point, but the GOT still has not asked to discuss a new program. Giorgiani said G-7 ambassadors could help by encouraging the GOT to consider taking out IMF insurance program now.

¶3. (C) Giorgani said the GOT is "between a rock and political hard place" regarding a new IMF agreement. After nine years of "stigma" under IMF programs, the GOT believes that it will achieve a political victory if it can weather the financial crisis without the IMF. It does not want to go into March 2009 local elections "holding hands" with the IMF. The problem is that the financial crisis could hit Turkey hard and the GOT would have no IMF "insurance" to fall back on, making the crisis deeper and more painful. Giorgiani noted that, of course, IMF funds come with strings attached in the

form of mandatory fiscal restraints. The GOT wants to spend more going into local elections in Spring 2009, and the IMF would oppose such spending. The Prime Minister understands that to have a Fund program, he would have to compromise on his policies, and he has not sorted out these conflicting priorities.

Economic Slowdown Already Here

¶4. (C) The team gave a downbeat summary of the macroeconomic situation Turkey faces. GDP growth last quarter was negative (quarter on quarter), and the current and next quarters will show zero growth.
The Fund projects GDP growth for 2008 at 2.5%. For 2009, Giorgiani said the Fund projects 2%, but he thought it would either be well above (4%) if things go well or below (around 0%) if things do not.

¶5. (C) Unlike in past crises, the Turkish private sector will feel the hardest impact this time because of its huge debt. The GOT will have some financial difficulties, but it can look to the banking sector if necessary (although crowding out the private sector in the process). Nor can Turkey hope to export its way out of this crisis, because demand is slowing in Europe (the destination for 50% of Turkish exports), Russia and the GCC. The only offset to this negative picture is the improving Current Account Deficit as energy and food prices fall. Giorgani noted that the growth in Turkey's CAD is essentially equivalent to its increasing energy bill.

Can Turkey Make It?

¶6. (C) The healthy banking system allows Turkey to approach the crisis from a position of strength, Giorgiani said. Banks have good liquidity thus far, and only about 10-12% of bank liabilities are offshore, meaning Turkey,s banks are not as heavily dependent on foreign financing as those in other emerging markets. However, Giorgiani said Turkey,s banks will face an increasing maturity mismatch as interest rates increase, and bank customers will have problems making payments due to the sharp drop in the value of the lira. Banks have some FX assets that they could liquidate to meet FX debts, but at the cost of diminishing their balance sheets and reducing their lending.

¶7. (C) Turkey,s gross financing needs are about $140 billion per year. At most, Giorgiani said, the IMF could lend around $25 billion. Normally, other lenders come in behind the IMF to close a financing gap. In the current environment, he was not sure where that additional financing would come from. The Turkish private sector has USD $10 billion in FX debt coming due in the next two months, mainly from syndication loans. If companies do not have foreign exchange to make these payments, they will have to buy it, and these large, lump-sum repayments will force down the lira further (the team heard that Turkish companies already are trying to pre-fund their FX debt coming due and that this was contributing to the lira's recent fall). The CBRT is reluctant to intervene in the FX market because it also faces USD $23 billion in non-resident bond investments that are being sold off slowly, and USD $50 billion in non-resident stock market investments that could be liquidated. Against these demands, the Central Bank's USD $77 billion in reserves are insufficient. Van Elkan noted that the lira's fall is part of the adjustment process, and will result in a sharp drop in imports and a restraint of credit. This will help reduce Turkey's gross financing needs over time.

¶8. (C) Fiscal restraint by the GOT is even more important than before. Every lira not spent is one that the GOT does not need to borrow and that remains available for the private sector. Giorgiani said the 2009 budget targets a 3% primary fiscal surplus, but the Fund believes the policies and assumptions in the budget are inconsistent with meeting that

target. The GOT's medium-term fiscal framework, which targets reducing Turkey,s debt to GDP ratio from 38% to 30% by 2015, will need to be revised, particularly with regard to privatization receipts.

¶9. (C) Giorgani said the Fund also is encouraging the GOT to prepare contingency plans if a banking crisis does hit Turkey. He said officials in the GOT and Central Bank have been through crises before, and the institutional framework is very good. The Bank Regulatory Agency has closed banks before and the Central Bank has provided liquidity support. What the GOT lacks is a coordinated, written plan of which agencies will do what in response to particular events. Absent that sort of planning, the GOT,s response is likely to be piecemeal, less effective, and possibly inconsistent.

¶10. (C) Later on October 23, Treasury Minister Simsek announced that Turkey "does not currently feel the neef for a new accord that would involve the use of new funds from the IMF" but that "technical discussions and work continues with the delegation that is in Turkey on a precautionary stand-by agreement." Despite this public announcement, Deputy Mission Chief Davide Lombardo told us October 24 that the GOT still has not formally requested a new IMF program.

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